DATE: March 31, 2004

TO: Brett Dahl, Administrator

FROM: Kristie Rhodes, Risk Finance Specialist

RE: 2002 Cost of Risk/Benchmark Analysis

The 2002 Cost of Risk Benchmark Analysis is complete. The 2003 RIMS Benchmark Survey™ is the first written summary of the results of a continuous data collection and analysis process conducted by Advisen Ltd. The electronic survey replaces the paper-focused survey conducted in the past by Ernst & Young and its predecessors. The RIMS Benchmark Survey™ was not completed for 2002 due to the implementation of the online system therefore the 2003 report was used for this analysis.

The 2003 survey was completed by 787 respondents. 63 of the respondents were government entities, the fifth largest group in this year's survey, against which RMTD is measured in this analysis. Revenue size could not be compared with that of other industries because respondents used a net operating budget as their primary exposure base. Most of the larger respondents in the government group (defined as those with operating budgets greater than $1 billion) are state governments, large cities, and very large counties. The State of Montana falls into this category with an operating budget of over $5 billion.

The total cost of risk and composition of the cost of risk dollar statistics presented in this report, as well as the data displayed in charts and graphs were obtained from the 2003 RIMS Benchmark Survey™, RMTD FY2002 SABHRS reports, Office of Budget and Program Planning and the Montana State Fund. This benchmark schedule compares Montana to other governmental respondents and uses the governmental industry median numbers presented in the survey.

Most of the trends and developments captured by the 2003 RIMS Benchmark Survey™ should not be surprising to risk managers and other insurance professionals. Premiums have overall increased dramatically since 2001. Insurance costs for every line of business have, on average, nearly doubled during that period, and tripled (or more) for a few hard hit lines. Average retentions have risen significantly. Buyers are increasingly taking advantage of captives and other alternatives to traditional insurance to manage costs and fill gaps in coverage.[i]

Beginning with tentative rate increases in a few lines in 1999, and reaching full steam by the end of 2001, the insurance industry is deep into the hardest market since the mid-1980s. Buyers have been faced with consecutive double-digit rate hikes in many insurance lines, and triple-digit increase in a few lines. Coverage terms have tightened, and some distressed lines have experienced capacity shortages. The current hard market comes on the heels of one of the longest and deepest soft markets in history. For over a decade insurance buyers enjoyed relentless price competition fueled by a powerful, sustained bull investment market that encouraged insurers to offset underwriting losses with investment income and capital gains. While the insurance market showed signs of turning as early as 1999, a confluence of events in 2001 and 2002 – the September 11 terrorist attacks, the collapse of the stock market and the subsequent fall in interest rates, a resurgence of asbestos claims, and a wave of corporate governance scandals beginning with Enron led to a rapid reversal in pricing.[ii]

The most current 2003 RIMS Benchmark Survey™ data indicates that rates are stabilizing in many casualty lines of business and are softening in property lines. The end of the hard market is heralded by a number of other factors. In short, a seemingly well-capitalized industry, greater market efficiency, a comparatively stable risk environment and improving investment income should encourage insurers to become more competitive.[iii]

<u>Total Cost of Risk</u>

The total cost of risk in the survey is measured by the sum of:

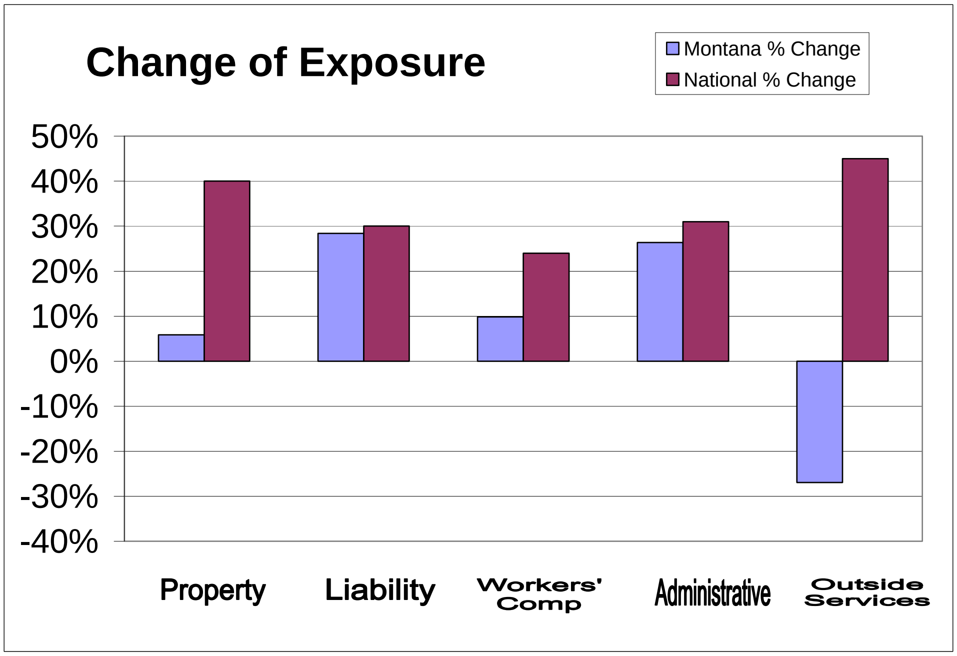
1) Insurance premiums for liability, property, and workers' compensation collected by the Risk Management & Tort Defense Division and the Montana State Fund;
2) Risk management/insurance department administrative budgets; and
3) Costs for outside services such as actuarial fees.

The term "cost of risk" refers to all costs associated with an organization's risk management functions-namely, net insurance premiums, retained losses, risk control, and loss prevention expenses, and administrative costs.

In 2003, the average cost of risk for all U.S. respondents increased 34% from the previous year. Government entities also experienced an increase from the previous year, which was a result of higher liability and property costs. Montana followed the increasing government entity trend, Montana's total cost of risk increased 17% from FY2001. Montana's total cost of risk in FY2001 was $15,242,485 and $17,763,291 in FY2002. The main factor contributing to the increase is a $1,452,931 or 28% increase in liability costs. Montana's property costs increased 6% from FY2001 to FY2002 while nationally the liability cost of risk increased 40%. This is due to the timing of the report. Montana's property cost increase significantly in F2003, which will be reflected in the next analysis. The schedule below illustrates changes by exposure for Montana's total cost of risk.

Exposure	**FY2001**	**FY2002**	**Change**	**Montana % Change**	**National % Change**
Property	$1,406,669	$1,489,290	$82,621	6%	40%
Liability	$5,114,255	$6,567,186	$1,452,931	28%	30%
Workers' Comp	$7,517,161	$8,256,907	$739,746	10%	24%
Administrative	$1,069,541	$1,351,415	$281,874	26%	31%
Outside Service	$134,859	$98,493	($36,366)	-27%	45%
Totals	$15,242,485	$17,763,291	$2,520,806	17%	

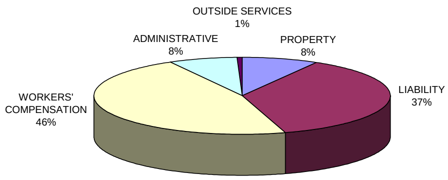
The survey shows that for all respondents nationally, all lines of exposure increased. Montana's cost followed the national trend by increasing in all areas except outside service costs, however Montana's costs did not increase as much as the national trend. See the comparison graph below.



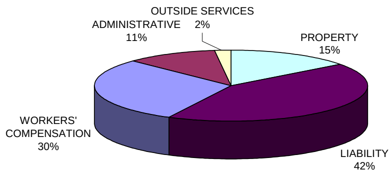
Composition of the Cost of Risk Dollar

The composition of the cost of risk dollar shows what percentage of each risk dollar is spent on each type of exposure. The following pie charts and bar graph compare the State of Montana to other governmental entities participating in the survey.

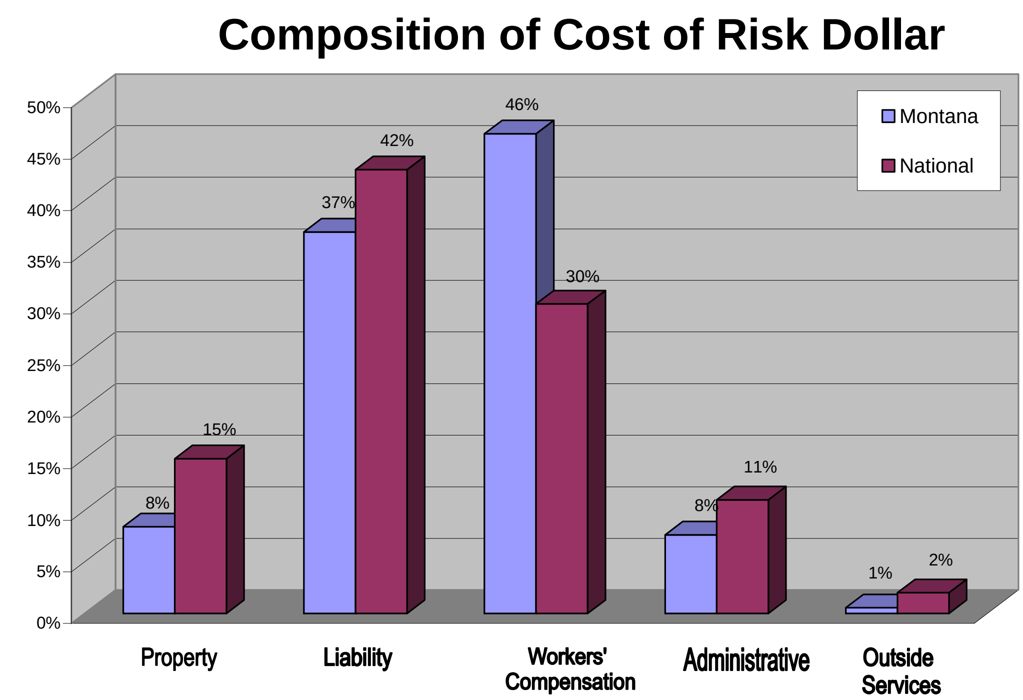
Montana Composition of Cost of Risk Dollar



National Composition of Cost of Risk Dollar

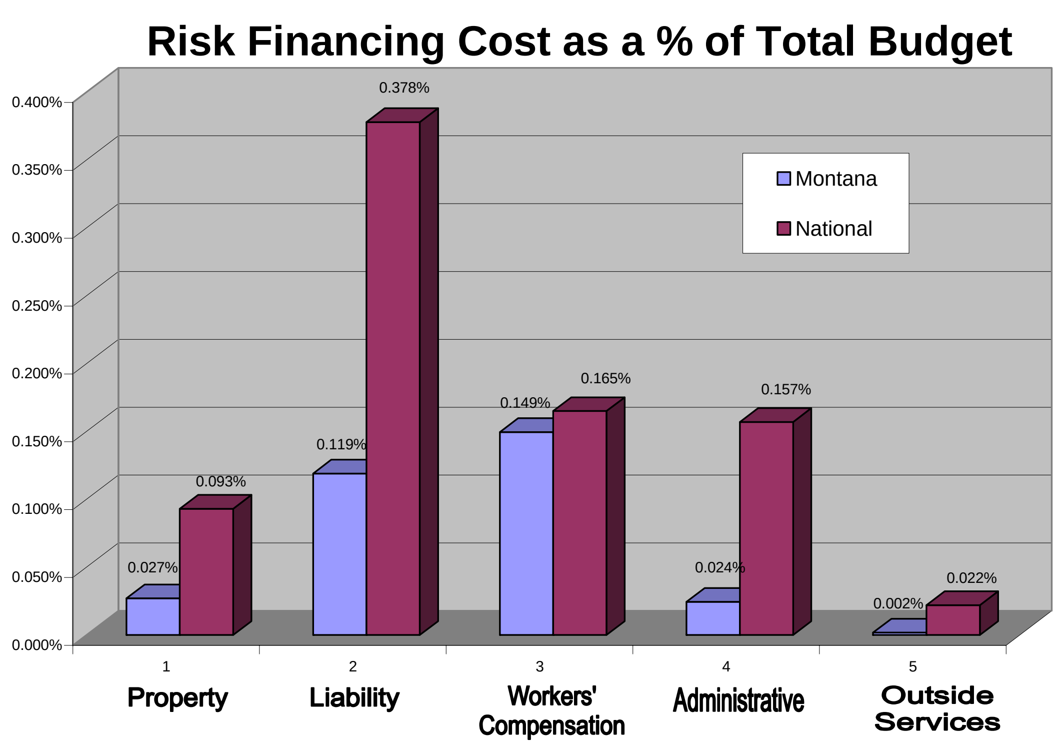


Montana spends almost half of its cost of risk dollar on workers' compensation at 46%. However, Montana spends less on all other exposures than the national average, spending 8% on property and 37% on liability where the national trend is 15% on property and 42% on liability.



<u>Risk Financing vs. Total Budget</u>

The bar graph below compares the risk financing cost as a percentage of the total State of Montana operating budget to other government entities. The graph shows that Montana spent less of their total budget on cost of risk exposures in all categories. Montana's risk cost as a percentage of the entire state budget, including the university system, is only 0.322%, slightly up from 0.319% in 2001. Nationally, government agencies are using 0.644% of their operating budgets on the cost of risk.



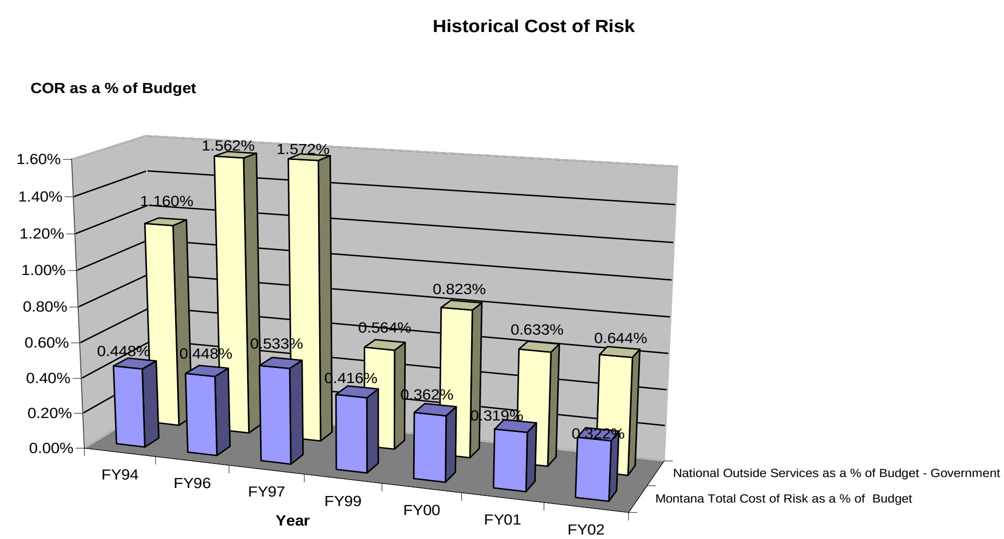
Summary

As with any study, one has to be careful in drawing conclusions and recognize the limitations of the underlying data. The survey is based on questionnaire information presented to a variety of different entities. Each of these entities uses different data gathering techniques and assumptions, as well as having different operating objectives. The survey, however, is the best source of information currently available from which to draw conclusions. The 2003 survey received very few responses from large entities in the government section, which contributed to a significant change in demographics for government respondents. Florida, Louisiana, Montana, and Oregon were the only state participants.

Montana's total cost of risk as a % of its operating budget has continued it's declining pattern, primarily due to the reduction in all costs except liability. In FY2002, we spent more of our cost of risk dollar on workers' compensation costs than the survey shows other governmental entities spent, and spent less of our dollar on property and liability exposures.

Montana is also consistent with one-third of government respondents whose property deductible/retention is between $101,000 and $250,000.

In terms of the amount spent on exposures as a percentage of the total budget, Montana spent less than the other governmental entities in the survey in every category measured. Overall, Montana spent 0.322% of the total operating budget on cost of risk and their counterparts spent 0.644% of their total budget on cost of risk last year and historically Montana has spent less, as illustrated in the chart below.



[i] 2003 RIMS Benchmark Survey™ page 8.
[ii] 2003 RIMS Benchmark Survey™ page 22.
[iii] 2003 RIMS Benchmark Survey™ page 26.